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DEPARTMENT OF STATE

BRIEFING MEMORANDUM

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TO: The Secretary

FROM: EB - Thomas O. Enders 07/15

Monthly Report

The Jamaica Monetary Accord and Beyond

The monetary agreement wrapped up at Jamaica embraces two sorts of decisions. First, of immediate importance, are the measures which will substantially enlarge the availability of IMF balance of payments support, particularly to developing countries. These measures include the liberalization of the Compensatory Financing Facility (the main element of your Development Security Proposal), the Trust Fund, and the enlargement of access to normal IMF credit drawings. The decisions on these matters represent a highly successful conclusion to our strategy for dealing with the financing needs of the developing countries over the critical next few years. We have already analyzed their significance in a separate report to you.

The second category involves decisions, mostly embedded in the package of amendments to the IMF Articles of Agreement, about the fundamental structure of the international monetary system. These decisions, in fact, have themselves settled very little about the shape of the future world monetary system. Paradoxically, this could be considered the essence of their major achievement in the area of long-term reform; but broad areas remain in which the struggle over important features of the system is likely, after some pause, to be renewed.

In geopolitical terms, the issues that have been resolved were those that had separated the industrialized countries--especially the United States and France. The issues remaining outstanding are ones which to a greater extent involve elements of

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north-south conflict. The package did provide extremely important benefits to developing countries--the short-term measures referred to above--but it left relatively untouched some basic issues involving longer-run LDC interests.

Gold and Exchange Rates: The essence of the U.S.-French compromises on the two central elements of the monetary reform agreement--exchange rates and gold--is to allow the ultimate shape of the system to be determined by evolutionary forces. In each case, the provisions are consistent with a broad range of eventual outcomes. The French essentially gave up their efforts to give the legal framework of the system a strong tilt in favor of a particular exchange-rate system--a generalized structure of fixed par values. At the same time, the more stringent U.S. proposals for agreements limiting the use of gold as a means of settlement among central banks were successively abandoned. Thus the final compromise has a kind of symmetry in its permissiveness.

There is less symmetry, however, in the most likely eventual outcome in these two areas. In both, the bargain seems very likely to turn out well from the current U.S. viewpoint. Within the agreed IMF Article IV on exchange obligations, countries may freely choose the exchange arrangements best suited to their own circumstances, so long as they adhere to general principles of good behavior. One section, to be sure, provides for the possibility of a re-establishment of a general system of par values. But an 85 percent majority of voting power would be required (the same majority as required for amendment), and individual countries would still be able to opt for alternative arrangements. Even apart from the current U.S. attitude and its veto position, it seems extremely unlikely that this provision would ever be activated. Instead, countries will pragmatically choose a variety of exchange arrangements, depending on their circumstances, as they do now. These choices could vary over time. For instance, countries becoming increasingly interdependent and achieving close integration of economic policy may well find greater advantages in mutual rate stability and form new or expanded joint floating arrangements. However, for larger and relatively more self-sufficient countries--and certainly between major country groupings--the advantages of rate

flexibility will remain clear. And the United States will be able to continue to reap the advantage of that flexibility (which we have enumerated in a previous report) as long as it desires to do so.

The ultimate outcome on the role of gold in the system may be less easy to forecast, but vital U.S. interests are also less clearly at issue. To be sure, gold has been removed from its central operational role in the IMF, and this is sure to be permanent. Gold could, however, conceivably be reactivated as a major means of official transactions among central banks, if there were to be a strong desire to do so. The present agreements among the G-10 countries (no pegging of the price of gold, and a global ceiling on the volume of official holdings) discourage, but certainly do not preclude this possibility; in any case they are temporary 2-year agreements. Nevertheless, it seems unlikely that official gold transactions will become commonplace. Certainly, the current attitudes of most countries are not favorable to such a result. With fluctuating market prices of gold, it will be difficult and cumbersome to arrive at satisfactory pricing arrangements for official transactions. The possibility of substantial disposals of IMF and national (including U.S.) stockpiles of gold heighten uncertainties. Attempts to peg the market price would probably not prove to be worth the effort. In sum, official gold transactions are likely to be limited to occasional cases where an individual country has a need for substantial liquidation beyond the capacity of the private market.

The Dollar and the SDR: Given this limited prospect for gold, it still remains unclear how the reserve asset system will evolve over the longer term. For the time being, of course, the dollar remains the dominant international reserve asset. The SDR is clearly being put at the center of the system as common denominator, but it is still a very long way indeed from replacing the dollar as the principal reserve asset. Despite the earlier agreement in principle that the role of both gold and reserve currencies should be reduced in favor of the SDR, there is no agreement on how this is to be done. The U.S. (Treasury), in fact, is backing away from its agreement to the earlier language on the reduction of the role of reserve currencies (on the ground that the premises of the earlier agreement have been altered by the adoption of floating rates). It is

now taking a distinctly unfriendly attitude towards proposals such as an IMF substitution account that would replace official reserve holdings of national currencies and/or gold with a special issue of SDRs.

We are not likely to be pressed hard for action on this residual issue of monetary reform for a while. Active pressure from the other industrialized countries has almost completely subsided, possibly as the result of adamant U.S. opposition and higher priorities in other areas of the monetary agreement. However, the developing countries are continuing to keep the issue alive, for reasons explored below. This issue, and other issues related to longer-term LDC objectives in the monetary area, may remain quiescent for a while in the relatively decorous monetary groups. But they will be re-emerging in the main north-south fora such as UNCTAD and possibly the CIEC.

<u>LDC Interests in Remaining Monetary Issues</u>: Two main continuing LDC objectives in the monetary area stand out. The first is related to their desire to obtain a continuous, assured flow of additional development financing on favorable terms, free from political or economic policy strings and from the vagaries of national legislative appropriations. One of the central proposals to achieve this goal is to tap the potential in the creation of international liquidity through creation of additional SDRs--i.e., the SDR-aid "link" proposal. This desire is thus closely related to LDC positions in favor of reducing the reserve asset role of gold and the dollar in favor of the SDR.

The LDCs have strongly protested the relaxation of barriers to the activation of official gold holdings at market prices. The reasons are obvious: LDCs generally hold proportionately much less gold in their reserves than do the developed countries, and the expansion in liquidity through activation of gold greatly reduces the prospect for additional SDR creation. Of course, the gold agreement had its short-run benefits, particularly the financing of the Trust Fund. Moreover, under the amended Articles, it will be possible to tap the remainder of IMF gold for LDC purposes again. But the LDCs will continue to work against gold as a freely usable reserve asset.

LDC interests in the role of the dollar are in fact mixed. Many LDCs have found it quite advantageous to hold dollars, in terms of convenience, interest earnings, and maintaining financial ties in New York. On the other hand, LDC groups, in their formal statements, continue to call for the replacement of the dollar with a "truly international reserve asset." The rationale is sometimes expressed in terms of achieving greater international control over liquidity creation or in terms of reducing the scope for the reserve currency country to "manipulate" the system. However, the underlying reason is more likely the knowledge that if international liquidity continues to be created through dollar accumulation, the scope for SDR creation again will be reduced or eliminated. (In addition to their desire for the SDR-aid "link", the LDCs have put forward ingenious schemes for dollar substitution accounts which would generate automatic aid flows.)

It may well be that maintenance of the dominant reserve asset role of the dollar and refusal to consider proposals for reducing this role is, and will continue to be, in the interests of the United States. It may also be that there is no convincing case to be made that the replacement of dollars by SDRs in official holdings would be in the interests of the system as a whole. It may be that our lonely opposition to the SDR-aid "link" is well founded in terms of the best interests of the system. However, all of these propositions require further examination and debate.

The second main LDC objective in the monetary area will be to tap the resources of the IMF for the support of their proposals in the commodity area. Specifically, their integrated commodity program has as a key element the establishment of a common fund to finance buffer stocks of important commodities. The LDCs are pressing for a relaxation of current IMF rules so as to allow the IMF to directly finance buffer stocks. (The present IMF buffer stock facility makes financing available only to member countries that need balance of payments assistance to enable them to contribute to international buffer stocks.) If direct IMF financing were available, this would be an important source of financing for the common fund. We will need to consider further how much we wish to stretch the basic purposes of the Fund to meet these demands.

Conclusions: The Jamaica monetary package will bring a period of repose in monetary issues among the industrialized countries, allowing the system to evolve in a pragmatic fashion, and defusing the conflicts that have troubled our relationships, especially with the French. And LDCs have received a substantial payoff in the package which should have a beneficial effect on north-south relations. But we will still need to deal with some longer-term monetary issues in the context of our continuing efforts to improve our relationships with the developing world.

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